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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-828

EDWARDS & HANLY,
Petitioner,

v.

WELLS FARGO SECURITIES CLEARANCE CORPORATION,
Respondent.

On Petition For a Writ of Certiorari To The United States Court of Appeals For The Second Circuit

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RESPONDENT'S BRIEF IN OPPOSITION

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Wells Fargo Securities Clearance Corporation (herein "WFSCC") respectfully requests that this Court deny Edwards & Hanly's petition for writ of certiorari seeking review of certain parts of the Second Circuit's opinion in this case, reported at 602 F.2d 478.

QUESTIONS PRESENTED FOR REVIEW

Petitioner Edwards & Hanly (herein "E&H") presents questions for review (Petition ("P."), pp. 2-3) which are either not in this case or not critical to its resolution.

Question One (P., p. 2) is whether certain duties of broker/dealers under Regulation T are defined solely by "objective" standards or by "subjective" standards, with E&H claiming that the Court of Appeals erroneously used solely "objective" standards. However, the Second Circuit did not apply solely "objective" standards; it applied a "subjective" test in line with rulings of other courts (Petition Appendix ("P.A."), pp. 17a-25a, 27a).

Question Two (P., p. 2) is whether a broker/dealer's violation of Regulation T *or* its negligence in failing to buy in securities for the account of a defaulting customer is a complete bar to such broker/dealer's recovery of damages. However, the Second Circuit did not so conclude. Instead, it held that since E&H's monetary loss was caused by its own actions, careless indifference and lack of due diligence, E&H could not recover its monetary loss from WFSCC (P.A., pp. 16a-25a, 27a). In so holding the Second Circuit found that E&H's lack of due diligence was established by numerous factors, including E&H's conscious violations of Regulation T *and* E&H's "careless indifference to the ordinary and accessible means of information" (P.A., pp. 16a-25a, 27a). At no point in its opinion did the Second Circuit indicate that a broker/dealer's Regulation T violation *or* negligence, either standing alone, is a complete bar to the recovery of damages by such broker/dealer.

Question Three (P., p. 3) assumes that the Second Circuit engaged in improper appellate procedure and found facts not supported by the record in this case. The Court

of Appeals applied the law to the facts in the record and clearly has *not* "so far departed from the accepted and usual course of judicial proceedings . . . as to call for an exercise of this court's power of supervision." United States Supreme Court Rule 19(b).

STATEMENT OF THE CASE

WFSCC relies on the statement of facts in the opinion of the Court of Appeals (P.A., pp. 3a-12a). E&H's statement of the case is inaccurate in certain important respects:

(1) The District Court did not find that WFSCC was an aider and abettor of Richardson as claimed by E&H (P., p. 5). Rather, the District Court found that WFSCC's employee Werba was an aider and abettor of Richardson and that WFSCC was vicariously liable to E&H either on the theory that WFSCC was Werba's principal or on the theory that WFSCC was a control person and had failed to adequately supervise Werba (P.A., pp. 56a-58a). In addition to disagreeing with the District Court's conclusion that WFSCC could be liable to E&H by reason of inadequate supervision of Werba (P.A., pp. 15a-16a), the Court of Appeals found that Werba's aiding and abetting liability had not been established since (i) Werba did not substantially assist Richardson in its fraud (P.A., p. 12a) and (ii) it was not clear that Werba had the required degree of scienter (P.A., p. 14a-15a). The Court of Appeals rejected the "but for" theory of causation applied by the District Court (P.A., p. 13a) and agreed with the District Court that Richardson's fraud "was not the short selling but the failure by Richardson to tell E&H that it was selling short" (P.A., pp. 12a, 51a). The Court of Appeals also refused to decide whether vicarious liability could arise based on agency principals (P.A., pp. 15a-16a). E&H has not challenged any of these rulings in this Court.

(2) There is no evidence in the record to support E&H's assertion that Werba knew the type of accounts Richardson maintained with broker/dealers, including E&H (P., p. 5). The District Court found that Werba knew that Richardson's accounts were cash delivery vs. payment accounts and should have known that short sales could not be made in such accounts (P.A., p. 53a). As pointed out to the Court of Appeals, there is no evidence in the record to support this finding.

(3) The Court of Appeals did not hold that "the tolerance as an industry standard of 3 week delays in delivery from third market brokers constituted a violation of Regulation T" (P., p. 8). The Court of Appeals did not acknowledge the existence of such an industry standard. The District Court acknowledged that brokers' delays of over three weeks were tolerated and that brokers were allowed more time to effect deliveries than was accorded retail customers (P.A., p. 67a). To the extent this finding was based on Mr. Monihan's testimony, it is clear that Monihan was talking about fails in the context of exchange contracts between member firms acting as brokers (P.A., pp. 79a-80a). As the Court of Appeals correctly noted, Richardson was a customer of E&H with respect to all transactions at issue in this case and the Richardson account is held to the same standard as any retail customer under Regulation T (P.A., p. 18a).

(4) The Court of Appeals did not reject a "totality of circumstances" test in determining whether there was a violation of Regulation T (P., p. 8). After reviewing the totality of the circumstances, the Court of Appeals concluded as a matter of law that E&H failed to exercise due diligence, citing as one primary cause E&H's failure to comply with Regulation T.

REASONS WHY THE WRIT SHOULD BE DENIED

There is no reason for this Court to review the Second Circuit's opinion in this case. The decision of the Court of Appeals is not in conflict with decisions of other courts of appeals or with any decisions of this Court. There is no important question for this Court to review. Nor is there any occasion for this Court to exercise its supervisory authority over lower federal courts. The Second Circuit's decision is based upon the complex, unusual and unique facts of this case.

I

THE SECOND CIRCUIT'S ANALYSIS OF A BROKER/DEALER'S DUTIES UNDER REGULATION T IS IN ACCORD WITH ANALYSES OF OTHER COURTS. NO IMPORTANT QUESTION OF FEDERAL LAW IS PRESENTED BY THIS CASE.

In analyzing the duties of E&H (a broker/dealer) under Regulation T concerning sales in a cash account, the Second Circuit followed the principles set forth in the leading case of *Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972). These same principals have been followed in other reported cases involving analogous factual situations. *See, e.g., Grimes, Hooper & Messer, Inc. v. Pierce*, CCH Fed. Sec. L. Rptr. ¶ 95,341 (C.D. Ca. 1973), *aff'd per curiam*, 519 F.2d 1089 (9th Cir. 1975); *Thomson McKinnon Securities, Inc. v. Hornung*, 69 App. Div. 2d 118, 419 N.Y.S.2d 526 (1979).

E&H does not quarrel with the *Naftalin* decision but rather argues that the Second Circuit failed to take into

account the past dealings of Richardson (E&H's customer) with E&H, including Richardson's history of late deliveries, as required by *Naftalin* (P., pp. 10-11). This is simply not so. The Second Circuit stated:

> "Its [E&H's] sporadic inquiries of the clearing agent [WFSCC] were not legally sufficient in the circumstances, considering the size of the 'fails,' the history of the dealings with Richardson, and the omission to observe the requirements of even a relaxed interpretation of Regulation T and of the Commission's rules. Moreover, if there was an intervening efficient cause for its loss, it was its reliance on the responses of Richardson itself to sporadic inquiries. These responses were evasive, and E&H had no right to rely on them unless they afforded a 'credible' reason for the delay in delivery of the securities. See *Naftalin & Co. v. Merrill Lynch, supra,* 469 F.2d at 1177 & n.14. Since the transactions were effected directly between broker-dealer (E&H) and broker-dealer (Richardson), it is quite inexplicable that credible explanations for late delivery should not have been demanded of Richardson itself. This failure to press Richardson for the specific reasons for the particular delays and whether the purported long sales were not, in fact, short sales, can only be attributed to E&H's desire for commissions and its willingness to extend credit, if necessary, in the cash account." (P.A., p. 19a)

E&H appears to be arguing (P., pp. 9-13), as it did to the Second Circuit, that as long as it reasonably believed that securities sold by Richardson would be delivered *at some time,* it did not violate Regulation T. E&H totally misses the point of its Regulation T obligation. Regulation T requires not only a good faith belief that securities will be delivered, but also a good faith belief that such securities are owned by the customer and that delivery will be made promptly. Both requirements are found in Section 4(c)(1)(ii) of Regulation T,[1] and the *Naftalin* result turned upon the existence of the good faith belief and the meaning of the word "promptly" in relation to the actions of the claimant broker/dealers (469 F.2d at 1176-1177).

Success for E&H in this case would be dependent upon this Court importing into Regulation T the concept that, because of an alleged but unproved industry practice of ignoring Regulation T when the customer is a third market firm, a broker/dealer need not have (i) a good faith belief that the security is owned by the customer, or (ii) an agreement with the customer that the security will be delivered promptly, until some point after three weeks from the settlement date. Such a concept would be in conflict with the basic purposes of Regulation T. *See Pearlstein v. Scudder & German,* 429 F.2d 1136 (2nd Cir. 1970), *cert. denied,* 401 U.S. 1013 (1971).

To accept E&H's argument that the Second Circuit's decision inhibits or impedes market efficiencies (P., pp. 12-13) is to accept the argument that applicable law does so.

In concluding its first argument (P., p. 13), E&H states that it is "essential that this Court determine the appropriate standards required by Regulation T." It is difficult to see why it is "essential" since (i) the requirements of Regulation T in this regard are specific, (ii) lower courts have uniformly defined a broker/dealer's duties under Regu-

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1 Section 4(c)(1)(ii) of Regulation T, 12 C.F.R. § 220.4(c)(1)(ii), reads as follows:

> "In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may: . . . (ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be *promptly* deposited in the account." (Emphasis added.)

lation T concerning sales in a cash account, and (iii) the Second Circuit's decision in this case is in accord with the express requirements of Regulation T and the court decisions with respect thereto.

II

THE SECOND CIRCUIT'S DECISION IS NOT IN CONFLICT WITH DECISIONS OF OTHER COURTS OF APPEALS OR BASED UPON UNSETTLED LEGAL PRINCIPLES.

A. The Second Circuit Did Not Rule, As Claimed By E&H, That A Broker/Dealer's Negligence Or Violation Of Regulation T Is A Complete Bar To The Recovery Of Damages By Such Broker/Dealer. The Second Circuit Ruled That Where A Broker/Dealer's Own Conscious Acts, Careless Indifference And Lack Of Due Diligence (Including Regulation T Violations) Caused Its Own Loss, It May Not Recover Damages From WFSCC On Secondary Liability Theories.

E&H's claim (P., pp. 13-16) that the Second Circuit ruled that negligence *or* a Regulation T violation is a complete defense to a securities fraud action misconstrues the Second Circuit's opinion. The Second Circuit held that based upon all the facts and circumstances of this case, E&H (a broker/dealer) may not recover damages from WFSCC (on secondary liability theories) where E&H's own conscious acts, careless indifference and lack of due diligence caused its own loss (P.A., pp. 16a-25a, 27a). The Second Circuit pointed to numerous factors in so holding, including, among others, (i) "E&H's desire for commissions and its willingness to extend credit" (P.A., p. 19a); (ii) "its careless attitude in marking the Richardson sales 'long' " (P.A., p. 18a); and (iii) its conscious assumption of the market risk (P.A., p. 21a).

B. E&H's Attempt To Classify Its Actions As Merely Constituting Negligence Is Not In Accord With The Second Circuit's Opinion And Applicable Law.

E&H attempts to imply (P., pp. 13-16) that its actions merely constituted negligence. The Second Circuit in this case did not so hold. The Second Circuit characterized E&H's actions utilizing the following terms: (i) "careless attitude" (P.A., p. 18a); (ii) "desire for commissions and willingness to extend credit" (P.A., p. 18a); (iii) "Edwards consciously assumed a market risk for E&H" (P.A. 21a); and (iv) "indolence and folly, or a careless indifference to the ordinary and accessible means of information" (P.A., p. 25a).

E&H also assumes that the Second Circuit found the violation of Regulation T (and thus Section 7 of the Securities Exchange Act of 1934, the "Exchange Act") to be the equivalent of a negligence finding. Even forgetting the Second Circuit's description of the violation as a "conscious" violation (P.A., p. 21a), the Second Circuit's finding of a Regulation T violation based principally upon a failure to investigate constitutes a finding of willfulness. "Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term "willful" in the Exchange Act.' " *Hanly v. SEC,* 415 F.2d 589, 595-596 (2nd Cir. 1969); *Dlugash v. SEC,* 373 F.2d 107, 109 (2nd Cir. 1967); *Quinn & Co. v. SEC,* 452 F.2d 943, 947 (10th Cir. 1971), *cert. denied,* 406 U.S. 957 (1972).

C. The Second Circuit's Decision In This Case Is Not In Conflict With The Decisions Of Other Circuits.

E&H claims a conflict between the decision of the Second Circuit in this case and rulings in the Fifth, Seventh and Tenth Circuits, citing *Dupuy v. Dupuy,* 551 F.2d 1005 (5th Cir. 1977), *cert. denied,* 434 U.S. 911 (1977), *Sundstrand*

Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977), and *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (P., p. 14). These cases do not rule out the concept that a plaintiff's conduct may constitute a bar to recovery but rather speak of the type of conduct of the plaintiff which will defeat recovery. The *Dupuy* decision speaks of the required conduct as "due diligence," measured by a reckless standard in cases where the defendant is guilty of scienter (*Dupuy, supra*, 551 F.2d at 1023). The *Holdsworth* and *Sundstrand* decisions speak in terms of plaintiff's conduct which constitutes "contributory fault . . . gross conduct comparable to that of defendant," and in terms of plaintiff's conduct which results in a failure to establish justifiable reliance and hence causation (*Holdsworth, supra*, 545 F.2d at 693-694; *Sundstrand, supra*, 553 F.2d at 1048). All three decisions state that recklessness or intentional conduct of the plaintiff (even a non-broker/dealer plaintiff) serves as a defense to a Section 10(b) and Rule 10b-5 fraud action where the defendant's conduct involves scienter (*Dupuy, supra*, 551 F.2d at 1020; *Sundstrand, supra*, 553 F.2d at 1048; *Holdsworth, supra*, 545 F.2d at 693).

The Court of Appeals in this case quoted from *Hirsch v. du Pont*, 553 F.2d 750, 763 (2nd Cir. 1977), the proposition that "the securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment" (P.A., p. 17a). In this case as in *Hirsch*, the plaintiff was a broker/dealer and the defendant was found to have no fiduciary or quasi-fiduciary duty to the plaintiff. All three cases cited by E&H, *Dupuy, Sundstrand* and *Holdsworth*, involve non-broker/dealer plaintiffs to whom the defendant, an alleged primary violator, owed a fiduciary or quasi-fiduciary duty.

WFSCC respectfully submits that even if E&H's actions merely constituted negligence, the Second Circuit's opinion in this case would not create a conflict with decisions of other Circuits that would require resolution by this Court.

The Fifth, Seventh and Tenth Circuits in *Dupuy, Sundstrand* and *Holdsworth* held that, in light of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the plaintiff's negligence does not bar such plaintiff from recovery when the defendant's liability is predicated on a finding of scienter. These cases recognize that where the defendant's liability is predicated on negligence, negligence of the plaintiff in failing to exercise due diligence will bar plaintiff's recovery. In this case the District Court found that liability could be imposed on WFSCC only vicariously based either upon the failure by WFSCC as a control person to adequately supervise Werba under Section 20(a) of the Exchange Act or upon agency principles (P.A., pp. 56a-58a). The Court of Appeals concurred that if liability existed at all, it would exist on those theories (P.A., p. 15a). The Fifth, Seventh and Tenth Circuits have not decided what standard of conduct would be imposed on a plaintiff seeking damages from a defendant on those theories.

WFSCC respectfully submits that if the Fifth, Seventh and Tenth Circuits were to be presented with a case of the nature of this case or *Hirsch v. du Pont, supra*, those Circuits would rule with the Second Circuit and deny the recovery of damages, particularly in light of the special and stringent duties placed upon broker/dealers by the federal securities laws. *See e.g., Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), *aff'd in part*, 570 F.2d 38 (2nd Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); *Zweig v. Hearst Corporation*, 521 F.2d 1129, 1135 (9th Cir. 1975), *cert. denied*, 423 U.S. 1025 (1975).

E&H's claimed conflict among the circuits is non-existent.

D. This Case Does Not Raise The Question Whether An Investor Has A Private Cause Of Action For Damages Againgst A Broker/Dealer For A Violation Of Regulation T.

The circuit court cases referenced by E&H (P., p. 15), concerning whether an investor has a private cause of action for damages against a broker/dealer for violation of Regulation T in light of the enactment of Exchange Act § 7(f) and Regulation X, have no applicability to this case. This case does not involve the "offensive" use of a Regulation T violation by an investor who is also a margin rule violator; instead, it involves the "defensive" use of a Regulation T violation by a non-margin rule violator as one of the reasons for denying the award of damages to the violating broker/dealer. Even if an investor does not have a private right of action for margin rule violations, that does not mean that such violations cannot serve as a defense, either on the theory that violation by plaintiff is itself a defense (as held by *Naftalin* and *Grimes, Hooper*) or that it is evidence that the plaintiff broker/dealer's loss was caused by its own willfulness, recklessness and lack of due diligence.

This should particularly be the case where, as in this case, a broker/dealer Regulation T violator (E&H) is suing a non-violator of the margin regulations (WFSCC) on secondary liability theories. Broker/dealers have full responsibility for complying with Regulation T (*Naftalin*, 469 F.2d at 1181). and there is no legitimate basis for imputing Richardson's Regulation X violation to WFSCC, particularly since WFSCC had no control over Richardson.

To say that WFSCC cannot raise Regulation T as a defense is to say that no defendant can raise a violation of

the securities laws by a plaintiff as a defense to the recovery of damages. That result would not encourage compliance with the securities laws.

III

THE COURT OF APPEALS EXERCISED PROPER APPELLATE PROCEDURE AND THE RECORD SUPPORTS ITS DECISION.

E&H's challenge to the facts relied upon in the decision of the Court of Appeals will not withstand scrutiny if the record is brought before this Court.

E&H's first and presumably most important claim is that there is no support in the record for the proposition that "E&H delivered stock of its own customers or other brokers to cover the Richardson fails by either borrowing the stock or using stock in the house" (P., p. 16). In the District Court, Arthur M. Foote, Jr., head cashier of E&H, testified that on a failed delivery by Richardson of Halliburton stock, he was fairly certain that E&H had closed out the street side by netting the stock out by a subsequent purchase of another customer, by using stock in customers' margin accounts or by borrowing stock from firm accounts, although he didn't know which (Joint Appendix in the Court of Appeals ("J.A."), pp. 597-598). He also testified that in the beginning of April, 1975, E&H had pressure from the street on stock sold by Richardson because E&H was no longer a major retail house. It was his practice to check the availability of the box, bank loans, and borrowing "wherever I could get the stock, if I were making delivery, if I had pressure from the street" (J.A., pp. 598-599).

In further stating that no authority was cited by the Court of Appeals that such conduct violated any law, E&H ignores the citation by the Court of Appeals to Rule 10a-2(a) under the Exchange Act which is set forth in full

in E&H's Petition (P.A., p. 95a). That Rule is clearly violated by such arranging for borrowing under the circumstances presented in this case.

As to E&H's second point (that the Court of Appeals erroneously assumed Richardson could have engaged in legitimate short sales — P., p. 17), E&H knew that Richardson was a third market firm acting as principal with matching buyers and sellers being its primary business. (J.A., p. 418). There is no evidence in the record to support the conclusion that Richardson could not engage in legitimate short sales. In fact Richardson could do so if it made a sale in anticipation of making a purchase involving excess stock or if it made a short sale unrelated to its primary business. E&H's duty of inquiry should have been ever present.

The third and fourth points discussed in E&H's Petition (whether deliveries were inordinately late and whether E&H's reliance on Richardson's responses was reasonable in light of the partial deliveries made — P., p. 17) clearly involve questions of the appropriate interpretation of the facts in light of the legal duties imposed upon E&H, rather than a resolution of the underlying facts. E&H fails to distinguish between appellate fact finding, which the Court of Appeals did not engage in, and the application of the law to those facts, which is the province of the Court of Appeals. The application of a legal standard to the facts is not a finding of fact within Rule 52(a). *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1200 n. 3 (2nd Cir. 1978); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 15 (2nd Cir. 1977); *In re Hygrade Envelope Corp.*, 366 F.2d 584, 588 (2nd Cir. 1966).

With respect to the fifth point (wrongful attribution of negligence to E&H based in part on the fact that other brokers ceased doing business with Richardson — P., pp.

17-18), there is clearly no appellate fact finding involved. The Court of Appeals merely repeated (and quoted from) the decision of the District Court below: "Beginning as early as February 1975, Richardson's bigger brokers, E. F. Hutton, B. C. Christopher and North American Equity (as well as Kaufman & Co.) informed Richardson that they were buying in their accounts with Richardson and would no longer do any business with it 'because of its consistently late deliveries of stock that it had sold to them.' 458 F.Supp. at 1117." (P.A., p. 7a)

The Court of Appeals properly treated the issues before it as mixed questions of law and fact as to which it was not bound by Rule 52(a). *Mamiye Bros. v. Barber Steamship Lines, Inc.*, 360 F.2d 774, 776-78 (2nd Cir. 1966), *cert. denied*, 385 U.S. 835 (1966). A fair reading of the decision would also lead to the conclusion that the Court of Appeals was "left with the definite and firm conviction that a mistake has been committed," thus justifying a reversal within the test set forth in *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

CONCLUSION

No amount of strained argument can convert this case into one warranting review by this Court. The Second Circuit's decision below turned on its own facts and, insofar as the issues raised by E&H's Petition are concerned, affects no one but the parties to this case. Moreover, independent grounds cited by Second Circuit, not challenged by E&H, indicate that this case was correctly decided.

There is no conflict of decisions among the Circuits. There is no important question for this Court to review. There is no need for this Court to exercise its supervisory powers.

For the foregoing reasons, it is respectfully submitted that E&H's Petition for a Writ of Certiorari should be denied.

Dated: December 21, 1979.

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